UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, Joseph T. Kelliher,
and Suedeen G. Kelly.

Southern California Edison Company Docket No. ER02-2119-000

ORDER CONDITIONALLY APPROVING SETTLEMENT

(Issued January 28, 2004)

1. In an order issued on August 16, 2002,[1] the Commission set for a trial-type hearing a dispute between Southern California Edison (SCE), Wildflower Energy, LP (Wildflower) and Coral Power, L.C.C. (Coral)[2] concerning certain income tax issues arising from an unexecuted Interconnection Agreement (IA) between SCE and Wildflower. The Commission directed that the hearing be held in abeyance to allow the opportunity for settlement between the parties. On June 17, 2003, a settlement agreement resolving these issues was filed by the parties. In this order, the Commission conditionally approves the contested settlement referred to us in a final report from the settlement judge.

BACKGROUND

2. On June 19, 2002, SCE filed a revised rate sheet to an unexecuted IA[3] between SCE and Wildflower that provides the terms and conditions under which Wildflower's Indigo generating facility is interconnected with SCE's transmission grid. SCE filed the revised rate sheet to update cost estimates for the interconnection facilities, consistent with the results of a facility study performed under the IA. Among other things, the IA

[1] Southern California Edison Company, 100 FERC ¶ 61,193 (2002) (August Order).

[2] Coral, an intervenor, has a tolling agreement with Wildflower under which Coral Energy Management (CEM), an affiliate of Coral, provides natural gas for the Wildflower generating facility and receives electricity from the facility. Under the arrangement, CEM takes title to the electricity and immediately sells the electricity to Coral at cost. Coral, in turn, markets the power and is responsible for bearing all interconnection costs that Wildflower incurs.

[3] The IA was accepted with modification in Southern California Edison Company, 97 FERC ¶ 61,148 (2001).

required Wildflower to make payments related to the income tax component of contributions (ITCC) to cover SCE's potential income tax liability arising from Wildflower's payments to SCE for the construction of interconnection facilities. However, Wildflower argued that recent Internal Revenue Service (IRS) rulings indicated that the IRS no longer treats such revenues received by a utility as taxable income. SCE argued that the law is unsettled on this point and therefore, requested that Wildflower reimburse it for the cost of seeking a private letter ruling (PLR) on the issue from the IRS. The parties were unable to agree to such an arrangement, however.

3. In the August Order, the Commission set the tax issues for hearing, but held the hearing in abeyance so that the parties could attempt to settle. On June 17, 2003, SCE filed an Offer of Settlement (Settlement) that resolves the issues set for hearing.

4. On July 7, 2003, Coral and Wildflower jointly filed initial comments in support of the Settlement. On July 7, 2003, Commission Trial Staff also filed comments supporting the offer of settlement, with modifications. Trial Staff objects to a provision in Article VII of the Settlement stating that if SCE incurs income tax liability because of a determination that the payments are taxable income and is unable, after using its best efforts, to recover the full amount of the liability from Coral and/or Coral's parent, "the Commission will allow [SCE] to include all unrecovered ITCC amounts, including interest and penalties other than interest and penalties which are the result of [SCE's] negligence or misconduct … in its base transmission rates pursuant to a filing under section 205 of the Federal Power Act." Trial Staff objects that this "regulatory backstop" provision contravenes Commission policy. It argues that the Commission has ruled that it will not guarantee that a regulated entity will recover its full costs, including taxes, in its rates. Trial Staff recommends that the second sentence of Section 7.1 be revised to read: "If SCE is unable, after using such best efforts, to fully recover the amounts owed and the Coral Holding guarantee fails to reimburse SCE for any tax liability, interest, and penalties actually sustained in connection with the Amounts, the Commission will allow SCE to file to include interest and penalties …"

5. Similarly, Trial Staff states that Section 11.5 of the settlement agreement should be modified to remove the opening clause, which states, "[o]ther than as expressly set forth in Article VII."

6. On July 17, 2003, SCE, Wildflower and Coral filed reply comments opposing the modifications proposed by Trial Staff. Coral and Wildflower argue that Trial Staff's proposed change would cause the entire agreement to unravel. They state that the purpose of the provision is only to ensure the final resolution of the tax issue. Coral and Wildflower further argue that it is extremely unlikely that SCE will turn to its rate base as a collection vehicle, since SCE's entitlement will arise, if at all, only after SCE has exhausted all efforts to collect the sums from Coral and Coral Holding. Moreover, Coral

and Wildflower argue, the Commission has approved settlements that included similar provisions that Staff argued purported to bind the Commission in future rate cases.

7. SCE's reply comments argue that the Commission should find it in the public interest for transmission ratepayers to bear the risk of an interconnecting generator not being able to fulfill its contractual commitment to pay to a transmission owner all just and reasonable tax-related interconnection costs. SCE states that the Commission does not allow a utility to hold security after issuance of a favorable PLR from the IRS. SCE contends, however, that as a matter of tax law, a PLR is valid only as long as certain conditions continue to be met. SCE argues that if circumstances changed so that these conditions were no longer met, it would be unable to collect from the generator its increased tax liability and the loss would fall on either its stockholders or its ratepayers. SCE also disputes Trial Staff's contention that the Commission's policy is not to guarantee a utility favorable rate treatment in a settlement and argues that there are circumstances in which future cost recovery is assured by the Commission.

8. On July 30, 2003, the Settlement Judge issued a final report.[4] On September 10, 2003, the Chief Judge issued an order terminating the settlement procedures.[5]

Discussion

9. The Commission finds that the Settlement Agreement, as modified below, is reasonable and in the public interest.

10. We agree with the modifications recommended by Trial Staff concerning Sections 7.1 and 11.5 of the agreement. Article VII contains a provision that attempts to bind the Commission in future rate cases. The Commission has stated that such a restriction on the Commission's authority to order changes to an agreement undermines its ability under the Federal Power Act to protect the public interest.[6] If SCE is unable for some reason to recover the full costs of its tax liability, SCE may make a Section 205 filing to propose to recover such costs in its rates; however, the Commission will not pre-authorize the recovery of these costs.

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[4] Southern California Edison Co., 104 FERC ¶ 63,025 (2003).

[5] Southern California Edison Co., 104 FERC ¶ 63,057 (2003).

[6] See e.g., Westar Generating, Inc., 100 FERC ¶ 61,255 at P 6 (2002); Turlock Irrigation District and Pacific Gas and Electric Company, 88 FERC ¶ 61,322 at 61, 978 (1999); Montana Power Company, 88 FERC ¶ 61,019 at 61,051 (1999).

11. Within 30 days of the date of this order, SCE shall file a compliance filing reflecting the revisions directed above.

The Commission orders:

(A) The settlement agreement in the above captioned proceedings is hereby conditionally approved, as discussed in the body of this order.

(B) SCE shall make a compliance filing as discussed in the body of this order.

By the Commission. Commissioner Brownell dissenting in part with a separate statement attached.

(S E A L)

Magalie R. Salas
Secretary

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Nora Mead BROWNELL, Commissioner *dissenting in part:*

1. This order approves the settlement on the condition that SCE delete the provision of the settlement agreement that would have provided a last resort cost recovery mechanism of certain income tax payments attributable to this interconnection. I do not support this condition.

2. Under the terms of the settlement, SCE could only invoke this recovery mechanism in the event that the safe harbor in its IRS private letter ruling terminated and SCE had failed, after using its best efforts, to recover the costs from Coral and its parent. Commission policy dictates that once an IRS private letter ruling is obtained, the only security a transmission owner may continue to demand from an interconnecting generator is a parental guarantee. While I support this policy as providing appropriate protection for interconnecting generators, I recognize that it leaves transmission owners exposed in the event that the parent guarantee becomes worthless by the time the transmission owner is assessed the tax liability. The approach taken in this settlement to address this problem seems a reasonable one to me. It is hard for me to imagine how any party could successfully argue that such tax liability was not a prudently incurred cost. The cases cited by Trial Staff and the majority in support of rejection of this settlement provision appear inapposite. The only case that Trial Staff cites in support of its protest, Tennessee, simply stands for the general proposition that ratemaking proceedings do not guarantee utilities full cost recovery. The cases cited in the order itself, Westar, Turlock, and Montana Power, dealt with the Commission's rejection of settlement language that would have held the Commission to the Mobile-Sierra public interest standard when making future revisions to that settlement. Moreover, the Commission has changed its policy in this regard and no longer rejects such language. See, e.g., Duke Energy Corporation, 104 FERC ¶ 61,048 (2003).

Nora Mead Brownell